FICA Taxes for Bona Fide Residents of Puerto Rico

Facts (the "Base Case")

Katy is a U.S. citizen who is a bona fide resident of Puerto Rico. Katy owns 100% of a Puerto Rican LLC ("PRLLC"). PRLLC is classified as a corporation for both Puerto Rican and U.S. tax purposes.

PRLLC performs services. All of the services take place in Puerto Rico. PRLLC receives arm's length service fee income from unrelated parties. PRLLC's gross service revenue is $1,200,000 and its total expenses, including a salary to Katy, are $500,000.

Katy's salary is $350,000. Her salary is reasonable in relation to the services she performs and is purely for services rendered.[1] All of the services Katy performs for PRLLC take place in Puerto Rico. Thus, all of her salary is Puerto Rican source income.[2]

U.S. Income Taxes On Katy's Salary

U.S. citizens are generally taxed in the U.S. on their worldwide income.[3] However, bona fide residents of Puerto Rico can exclude Puerto Rican-source income from their U.S. taxable income.[4] Because Katy is a bona fide resident of Puerto Rico and because all of the services she performs for PRLLC take place in Puerto Rico, she can exclude the $350,000 salary she receives from PRLLC from her U.S. taxable income.

Puerto Rico itself may impose an income tax on Katy's salary. However, such a Puerto Rican income tax is not a U.S. Federal income tax and is not collected by the U.S. Federal government. Instead, Puerto Rican income taxes are imposed by, and collected by, the Puerto Rican government.

1 Treas. Reg. §1.162-7(a). All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.
2 Code §861(a)(3) and Treas. Reg. §1.861-4.
3 Code §61(a) ("all income from whatever source derived"). *Cook v. Tait*, 265 U.S. 47 (1924).
4 Code §933.

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U.S. FICA Taxes on Katy's Salary

In general, the term "United States" when used in a geographical sense includes only the 50 states and the District of Columbia.[5] Thus, PRLLC is not considered a domestic corporation. Instead, it is considered a foreign corporation.[6]

The term "wages" is generally defined as "all remuneration for employment."[7] The term "employment" is defined to include any service performed by an employee within the United States.[8] For FICA tax purposes, the term "United States" is defined to include Puerto Rico.[9] Therefore, for FICA tax purposes Katy's services are performed by an employee within the United States. This means that her salary from PRLLC is considered wages, and the salary is subject to U.S. FICA tax.[10]

PRLLC would use Form 941 (PR) to report the wages and the FICA tax withheld to the IRS. PRLLC may also withhold Puerto Rican income tax from the wages. However, that Puerto Rican income tax is retained by the Puerto Rican government.

Alternative Facts

Assume the same facts as above, except that for U.S. tax purposes PRLLC has elected to be classified as a disregarded entity.[11] PRLLC continues to be classified as a corporation for Puerto Rican tax purposes.

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5 Code §7701(a)(9).
6 Code §7701(a)(4).
7 Code §3121(a).
8 Code §3121(b).
9 Code §3121(e) ("For purposes of this chapter * * * [t]he term 'United States' when used in a geographical sense includes the Commonwealth of Puerto Rico * * *.").
10 Code §3101(a) ("there is hereby imposed on the income of every individual a tax equal to 6.2 percent of the wages * * * received by the individual with respect to employment"). Code §3101(b) ("* * * a tax equal to 1.45 percent of the wages * * *"). Code §3111(a) ("there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to 6.2 percent of the wages * * * paid by the employer with respect to employment"). Code §3111(b) ("an excise tax * * * equal to 1.45 percent of the wages * * *").
11 Treas. Reg. §301.7701-3(a).

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U.S. Income Taxes On PRLLC's Income (Under the Alternative Facts)

If an entity with a single owner elects to be "disregarded as an entity separate from its owner", then "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[12] The entity is thus treated for U.S. Federal tax purposes "as having no existence separate and distinct from" its owner.[13]

If PRLLC has elected to be taxed as a disregarded entity for U.S. tax purposes, then its income and deductions are treated as income earned by Katy and deductions incurred by Katy. Under the Base Case, Katy had salary income of $350,000 and no deductions. Under these Alternative Facts, Katy does not earn a salary. Instead, payments between Katy and PRLLC are disregarded, and Katy has gross income of $1,200,000 and related deductions of $150,000 (total deductions of $500,000 less the disregarded salary of $350,000).

As described above, all of PRLLC's gross services income was derived from services performed in Puerto Rico. Thus, all of the gross income of $1,200,000 can be excluded from Katy's gross income under Code §933. Assuming that the $150,000 of expenses were properly allocable to the Puerto Rican-source income, then those deductions would be disallowed for U.S. tax purposes.[14] None of the net income of $1,050,000 would be taxable to Katy.

In the Base Case, Katy owed no U.S. income tax on her salary from PRLLC. Similarly, under the Alternative Facts, Katy should owe no U.S. income tax on her income earned through PRLLC.

U.S. Self-Employment Tax On PRLLC's Income (Under the Alternative Facts)

The U.S. imposes a tax on the self-employment income of every individual.[15] Self-employment income generally means net earnings from self-employment derived by individuals other than nonresident aliens.[16] Net earnings from self-employment means "the gross income derived by

12 Treas. Reg. §301.7701-2(a).
13 *Whirlpool Fin. Corp. & Consol. Subs. v. Commr.*, 154 T.C. 142 (2020).
14 Code §933(1) ("but such individual shall not be allowed as a deduction from his gross income any deductions * * * properly allocable to * * * amounts excluded from gross income * * *.").
15 Code §1401.
16 Code §1402(b).

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an individual from any trade or business carried on by such individual, less the deductions * * * which are attributable to such trade or business”.[17]

Because PRLLC’s activities are attributed to Katy, Katy is treated as deriving gross income from a trade or business and incurring deductions related to that trade or business. Thus, Katy has net earnings from self-employment of $1,050,000. These earnings will be subject to U.S. self-employment tax.

FICA Taxes (Under the Alternative Facts)

As described above, under the Alternative Facts PRLLC is classified as a disregarded entity for U.S. tax purposes. Therefore, payments between Katy and PRLLC are disregarded.[18] That is, Katy is not treated as receiving any salary from PRLLC for U.S. tax purposes. Under Puerto Rican tax law, PRLLC is classified as a corporation. Thus, under Puerto Rican tax law, Katy receives a salary and can be taxed in Puerto Rico on that salary. However, when PRLLC files its U.S. payroll tax returns, it should not treat Katy as receiving a salary. Therefore, none of Katy’s income should be subject to FICA taxes under the Alternative Facts.

17 Code §1402(a).

18 For certain employment tax purposes, PRLLC may be treated as a corporation. Treas. Reg. §301.7701-2(c)(iv)(A). However, with respect to Katy, PRLLC is not treated as a corporation. Treas. Reg. §301.7701-2(c)(iv)(C)(2) (A disregarded entity “is not treated as a corporation for purposes of employing its owner; instead, the entity is disregarded as an entity separate from its owner for this purpose and is not the employer of its owner. The owner will be subject to self-employment tax on self-employment income with respect to the entity’s activities.”).

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